No. 10594

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

WESTERN MESA OIL CORPORATION, and EL SEGUNDO OIL COMPANY,

Appellants,

vs.

EDLOU COMPANY, *et al.,* Landowners in El Segundo Community Lease No. Four-A, EDLOU COMPANY, *et al.,* Landowners in El Segundo Community Lease No. Two-B; A. A. McCRAY, Trustee, for holders of overriding royalties in El Segundo Community Lease No. Four-A, A. A. McCRAY, Trustee for holders of overriding royalties in El Segundo Community Lease No. Two-B; A. A. McCRAY, WM. H. RAMSAUR and F. R. C. FENTON,

Appellees.

APPELLANTS' REPLY TO BRIEF OF APPELLEES OF WELLS NO. 2 AND NO. 4.

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Appellees.

APPELLANTS' REPLY TO BRIEF OF APPELLEES OF WELLS NO. 2 AND NO. 4.

I.

Statement of the Case.

We take issue with the attempted restatement of the facts of the case that is contained in the brief of the appellees of Wells No. 2 and No. 4. These appellees recite that under the original plan of arrangement, which is attached as Exhibit A to the petition of the debtor for

relief under chapter XI, it was provided that the landowners' royalties should be paid prior to the payment of any other debts (Appellees' No. 2 and No. 4 Brief, p. 2). This plan of arrangement was later superseded by a revised plan of arrangement, and it was the revised plan of arrangement which was confirmed in these proceedings [R. 94]. The original plan provided that out of the gross proceeds derived from the production of the oil wells involved in the case, payment would be made as follows: (1) landowners' royalties (obviously current royalties), (2) necessary operating expenses of the corporation, (3) costs of administration, (4) claims having priority under Section 64 of the Bankruptcy Act, (5) claims of the holders of conditional sales contracts, (6) claims of unsecured creditors, and (7) claims of participating royalty interest holders [R. 7-9]. The first three categories contemplated current, administrative and operating expenses. Categories 4 to 7 inclusive referred to "claims" which were obligations accruing prior to the commencement of the bankruptcy proceedings. It is significant to note that the use of the word "claim" is not included in the first three categories. The order of payment was actually nothing else but a restatement of the order of payment prescribed in ordinary bankruptcy proceedings. The first three categories are placed ahead of the claims of creditors whose rights accrued prior to bankruptcy consistent with the provisions of Section 357(6) of the Bankruptcy Act of 1938, which provides that a plan of arrangement may include "provisions for payment of debts incurred after the filing of the petition and during the pendency of the arrangement in priority over the debts affected by such arrangement."

Appellees of Wells 2 and 4 state that the revised plan provided that "landowners' royalties would be paid in full in the same manner as priority claims where the facts disclosed that the landowners had not, prior to the filing of Debtor Corporation's petition in bankruptcy, waived their right of forfeiture of the oil and gas leases, either in writing or by their conduct" (App. No. 2 and 4 Br. p. 3). This statement would be accurate only if it included the further qualification that only landowners' royalties "which carry with them the right of forfeiture" are so preferred. The best evidence of what the revised plan provided is the provision contained in the plan itself, as follows:

> "Landowners' royalties which carry with them the right of forfeiture of the oil and gas leases under which such royalties are payable and where such right of forfeiture has not, prior to the filing of the petition in bankruptcy, been waived either in writing or by the conduct of the parties, will be paid in full in the same manner as priority claims. Where, however, the facts disclose that prior to the filing of the proceedings hereunder by the debtor, the landowners, by writing or by their conduct, have legally waived the right of forfeiture as to any of the unpaid royalties, the same will be treated the same as those in the class of unsecured creditors. Should any controversy arise as to the proper status of such claims of holders of landowners' royalties, the same shall be determined by the above entitled Court in the above entitled proceeding upon hearing after notice" [R. 81].

II.

Appellees Have Failed to Establish Themselves as the Holders of Landowners' Royalties With Right of Forfeiture.

Appellees of Wells 2 and 4 attempt to avoid the effect of their having failed at any time to have given notice of forfeiture, as required by the leases in question. In their reply to our Point I, appellees concede that the revised plan "provided that *under certain conditions* landowners' royalties would be paid in the same manner as priority claims" (App. 2 and 4 Br. p. 4). Thus far, we are in agreement. The difference between the contentions of the appellants and appellees lies in the question of what constituted those "certain conditions" which would entitle landowners' royalties to be paid in the same manner as priority claims. Appellees state that the only interpretation that could be given the clause would be that the claims would be paid in full providing the landowners had not by conduct or in writing waived their right to declare a forfeiture prior to the filing of the petition in bankruptcy. The interpretation of the provision contained in the revised plan is not difficult. The language is plain and unambiguous. The first sentence of the clause in question states the conditions which would entitle the holder of a landowner's royalty to allowance as a priority claimant. It reads as follows:

> "Landowners' royalties which carry with them the right of forfeiture of the oil and gas leases under which such royalties are payable and where such right of forfeiture has not, prior to the filing of the petition in bankruptcy, been waived either in writing or by the conduct of the parties, will be paid in full in the same manner as priority claims."

It is evident that not all landowners' royalties were entitled to payment in full in the same manner as priority claims. In order to qualify, the landowner's royalty must (1) carry the right of forfeiture; (2) there must be an absence of waiver of the right of forfeiture. The second category necessarily requires the existence of the first, or it would be meaningless. The question of the waiver of a right presupposes the existence of the right that is subject to waiver.

In order to qualify themselves as entitled to priority in this case, it was incumbent upon the appellees to prove that they met the two conditions aforementioned.

The record in this case will disclose that appellees failed utterly to meet the very first condition, to wit: that their rights included the right of forfeiture. In addition to that, the record discloses that had there been a right of forfeiture perfected by the giving of notices as required by the lease, the acceptance of royalty payments from the receiver and the conduct of the landowners in this case constituted a waiver of such right. Appellees of Wells 2 and 4 misstate our contention when they say, on page 5 of their brief, that we "contend that the landowners waived their rights to declare a forfeiture for non-payment of royalties by not giving the Debtor Corporation written notice that it was in default." It is not that the landowners *waived* their rights to declare a forfeiture so much as that they failed to *acquire* the right of forfeiture by not giving such notice as required by the lease to create the right to forfeiture. Appellees slough off rather than answer the effect of the cases cited by us in our opening brief which clearly set forth the rule that the right of forfeiture does not arise until (1) the notice required by the lease in question has been given, and (2)

the lessor has declared a default based upon the failure of the lessee to rectify the default within the time required by the notice. The cases cited hold that the existence of the forfeiture provision in the lease together with the existence of a default do not, in themselves, give rise to the right of forfeiture. The forfeiture provision creates an option on the part of the lessor which he may or may not exercise. He may, as the landowners did in this case, accept current rental payments and avoid giving notice of default as required by the lease. Until such notice is given, he does not have the right of forfeiture. Appellees state that the cases which we cited involved suits to recover possession or quiet title. The right of forfeiture was essential to the maintenance of such actions. In order to determine whether or not the relief could be granted in such cases, the court had to determine the existence of the right of forfeiture. Similarly in this case the court was called upon to determine the existence of the right of forfeiture. These cases all hold that the right of forfeiture does not accrue in the absence of the requisite notices under the lease being given.

35 *C. J.* #248, p. 1075:

> "Inasmuch as it is optional with the lessor whether to avail himself of the breach of a covenant giving him a right to forfeit the lease, it follows that, if he desires to forfeit, *he must manifest his intent by some clear and unequivocal act during the term*, such as by a reentry, the bringing of a suit to recover possession, *or by giving a notice of a character designated in the lease* * * *. Where the landlord claims a forfeiture, he must show that he has done everything necessary to be done on his part to perfect such right." (Emphasis supplied.)

As the Supreme Court of the State of California, in the case of *Jameson v. Chanslor-Canfield M. Oil Co.*, 176 Cal. 1, 6, said:

> "* * * The event which causes the forfeiture is the failure of the lessee to perform any of the conditions embodied in the lease for a period of thirty days after a notification. By the language of the paragraph this notification must be given 'by the parties of the first part.' *It is only upon the giving of this notice and the failure to perform the conditions mentioned therein that the forfeiture can be declared. This is the condition which must happen in order to give a right to declare a forfeiture.*" (Emphasis supplied.)

The purpose of the notice is to enable the lessee to cure the default within the prescribed time.

> *Guffey v. Smith*, 237 U. S. 101, 35 S. Ct. 526, 59 L. Ed. 856, 865,

in which the court said:

> "Under it the lessor could have demanded the rent in arrears, and have notified the complainants in writing that, unless payment was made within a time named in the notice, not less than 5 days thereafter, the lease would be terminated; and upon a failure to pay within that time he could have treated the lease as ended. But there was no such demand or notice, and consequently no failure to comply with either."

Not only was it necessary to establish the giving of the notice itself, but it was necessary for the appellees to establish that the notice was a proper one and joined in by all of the tenants in common involved. These were community leases, and had the notice, if given, omitted as much as one of the lessors, the notice would have

been insufficient to have predicated a rise of the right of forfeiture. Thus, in the case of *Axis Petroleum Co. v. Taylor*, 42 Cal. App. (2d) 389, at page 396, the Court held that the failure of one of the joint tenants to join in the notice of default rendered the notice of default insufficient. See also *Metzler & Co. v. Stevenson*, 217 Cal. 236.

The basis of the notice provisions in an oil and gas lease is to afford the lessee with a period of time after written notice within which he can rectify the default. Therefore forfeiture for a default is impossible until he has been given that notice and has exhausted the time afforded by such notice. In the leases involved in this case, provision was made whereby the lessees were given a period of ninety days after they received written notice from the lessors that unless they rectified the defaults within that ninety-day period forfeiture would be declared. Such notice was never given in this case, and it must follow that the right of forfeiture did not arise. There have been cases in which, under similar leasehold provisions, instead of giving notice that the lease would be forfeited if the default were not remedied within the prescribed time, the lessors gave notice declaring forfeiture. In such cases the courts have held that the notice was as if no notice had ever been given and the right of forfeiture did not arise.

> *Wellport Oil Co. v. Fairfield*, 51 Cal. App. (2d) 533;
>
> *Pierce Oil Corp. v. Schacht*, 75 Okla. 101, 181 Pac. 731.

According to the reasoning of appellees of Wells 2 and 4, "the notice of default and demand for payment within

a certain time is a necessary first step before a complete forfeiture can be declared, but until the right to give notice is shown to have been waived in writing or by conduct prior to the bankruptcy, the objection and the law cited by appellants do not seem applicable." (App. 2 and 4, Br. 5.) The statement is made with a significant failure to cite supporting authority. Appellees concede that the giving of the notice was a "necessary first step." We could not express it any better. The mere existence of the forfeiture clause would not give rise to the right of forfeiture.

> "The lease did not automatically terminate, because the grantee did not drill on the land described in the lease within one year. Notice in writing by the grantor was necessary to terminate the lease, and on receipt of notice the grantee was privileged to elect to keep the lease alive from year to year by paying an annual rent."
>
> *Brinkman v. Empire Gas and Fuel Co.* (Kan.), 245 Pac. 107.

> "The plaintiff in the court below has not complied with this prerequisite of the contract essential to obtaining a forfeiture, and no forfeiture can be granted."
>
> *Chapman v. Carlock* (Okla.) 230 Pac. 516, 519.

The right to forfeiture is created when the *last* of the acts necessary to create it has occurred. In this case the necessary first step was not taken.

> "Under this rule it must be admitted that forfeiture does not occur until the last of the acts which are to create it has occurred."
>
> *Downing v. Cutting Packing Co.*, 183 Cal. 91, 95.

In the *Downing* case, a notice of forfeiture was given. The court held that the notice did not serve to create the forfeiture, where there was a failure to follow through with the subsequent steps necessary to invoke such result.

> "A condition involving a forfeiture must be strictly interpreted against the party for whose benefit it is created."
>
> *Civil Code,* Section 1442.

Appellees of Wells No. 2 and 4 state that each day from March 20, 1942, to June 19, 1942, they had the right to give notice of default for non-payment of royalties (App. 2 and 4, Br. pp. 5, 6). They failed to exercise that right; therefore they did not have the right of forfeiture. Had they exercised their right, they were required to give the debtor corporation a period of 90 days within which to cure the default. Had the debtor then failed to cure the default within such period of 90 days, the landowners would then have had the right to declare a forfeiture of the lease in question.

> "* * * the lease and option agreement contained a clause requiring notification to be given, and * * * forfeiture could not be claimed until thirty days thereafter."
>
> *Templar Mining Co. v. Williams,* 23 Cal. App. (2d) 45, 52.

It is not just *any* notice that could possibly serve the purpose of creating the right of forfeiture. It must be a notice that meets the strict specifications of the lease.

> *Welport Oil Co. v. Fairfield,* 51 Cal. App. (2d) 533.

Where the lease provides that the lessor may declare a lease forfeited upon giving a 90-day notice, then a notice that the lessor has declared the lease forfeited is not in compliance with its terms and does not give rise to a forfeiture.

Pierce Oil Corp. v. Schacht (Okla.), 181 Pac. 731.

III.

The Acceptance of Current Royalties From the Receiver Constituted a Waiver of the Right of Forfeiture.

The very statement of the above mentioned proposition presupposes that the right of forfeiture had been created by the giving of proper notice. The appellants do not admit such right of forfeiture ever arose in this case. For argumentative purposes only, there will be an assumption that such right arose.

Appellees state that the revised plan limited consideration of waiver to acts committed prior to the commencement of the bankruptcy proceedings.

The revised plan does refer only to acts of waiver committed prior to the petition in bankruptcy. This was due to the fact that current royalties were being paid by the receiver, and since the royalties in question arose prior to the filing of the petition, the acts of waiver mentioned were those which took place prior to the petition. But the provision did not limit the debtor, or the new company from asserting any other grounds of objection. Thus in the very paragraph in question the plan provided:

> "Should *any* controversy arise as to the proper status of such claims of holders of landowners' royalties, the same shall be determined by the above

entitled Court in the above entitled proceeding upon hearing after notice." [R. 81.] (Emphasis ours.)

The plan also provided that:

> "If * * * there appear to be any objectionable claims filed, the debtor, or any party in interest, including the new corporation, shall have the right to object to the allowance of the same, and such alleged creditors shall participate in the plan as confirmed, only on the basis of the amount of their claims as may finally be allowed by this Court." [R. 84.]

The matter was heard below on the theory that waiver both before and after the filing of the petition in bankruptcy was involved. This placed an interpretation that dispelled any ambiguity that might otherwise have existed. We quote relevant portions of the transcript, to wit:

> "Mr. Hunt: I would like to have the record show, Your Honor, during the administration here the Receiver paid the current royalties.
>
> The Referee: I understand that" [R. 165].

It should be noted that the foregoing was without any objections of the appellees.

> "Mr. Dechter: It is our contention, Your Honor, that the landowners did not have to accept the rents if they wanted to rely upon their right of forfeiture. We contend they waived the right of forfeiture by their acts and conduct, both before and since the filing of the bankruptcy petition, by accepting royalty checks after they were due and prior to the filing of

bankruptcy petition, and by accepting royalty checks subsequent to the filing of the bankruptcy petition from the Receiver" [R. 189].

The appellees contended that they assumed that only waiver prior to the petition was involved [R. 200, 201].

"Q. Showing you a number of checks, Mr. McCray, made out on all these three wells, starting with August, 1942, down to October, 1942 * * * you received your share of those checks did you not? * * *

Mr. Bowker: Your Honor, I will offer my objection to that question on the grounds it is immaterial and irrelevant to this issue, inasmuch as those checks were received subsequent to the appointment of the receiver, and are not before this Court.

The Referee: It shows the conduct. I will overrule the objection" [R. 218].

Hence it is apparent that the Court resolved the issue of the materiality of conduct subsequent to the filing of the bankruptcy petition in favor of appellants by admitting the evidence over objections of appellees. Thus the findings of fact of the Referee with respect to Wells No. 2 and 4 recited:

"* * * the receiver for said debtor corporation has paid current royalties on said wells to the landowners as the same became due" [R. 70].

IV.

Although Acceptance of Royalties That Are Past Due Does Not Waive Right to Take Advantage of Subsequent Breach, It Is Necessary That Notice Be Given That Strict Adherence to Forfeiture Clause Would Be Made in the Future.

Appellees of Wells 2 and 4 contend that the acceptance of past due royalties on March 20, 1942 did not preclude the landowners from declaring a forfeiture from the breach of the continuing covenant to pay royalties from said date to the time the debtor corporation filed its petition under Chapter XI (App. 2 and 4 Br. 7). The first and obvious answer is that even if they might not have been precluded from doing so, the fact remains that they did not declare a forfeiture for such period. As heretofore pointed out, the only way they could declare the forfeiture was by notice, and it is undisputed that no notice of intent to declare a forfeiture was ever given.

But even such notice could not have been given until the debtor had been notified that further delays in the payment of royalties would not be tolerated.

We start with an assumption favorable to the appellees, to wit: that there was a time of the essence clause in the lease involved, although there is nothing in the record to such effect. Without such a clause, there would be no right to forfeit because of failure to make timely payment of royalties.

When once there has been an acceptance of payment not made punctually, the law is well settled that the right of foreiture is suspended until restored by the giving of a specific notice of intention to enforce it thereafter.

> *Boone v. Templeman*, 158 Cal. 290;
> *Stevenson v. Joy*, 164 Cal. 279;
> *Hoppin v. Monsey*, 185 Cal. 678;
> *LeBallister v. Morris*, 59 Cal. App. 699;
> *Wetherby v. Sinn*, 73 Cal. App. 98;
> *Pearson v. Brown*, 27 Cal. App. 125;
> *Miller v. Modern Motor Car*, 107 Cal. App. 42;
> *Lafoon v. Collins*, 212 Cal. 750.

"When rent is accepted by the lessor, with knowledge on his part that the lessee was every day violating the covenants of the lease, it was held that the lessor accepting rent could not declare a forfeiture without a reasonable prior notice that further noncompliance would not be waived."

> *Thornton on Oil & Gas*, vol. 2, #281, p. 532 (citing many cases).

V.

Receipt of Royalties for Current Months Serves as a Waiver of Right of Forfeiture for Failure to Pay Royalties Due for Prior Months.

Appellees of Wells No. 2 and 4 cite 109 A. L. R. 1267, 2 Summers Oil & Gas Law, p. 486, and *Duffield v. Michaels,* 97 F. 825 to support their contention that the receipt of rent for current months will not serve as a waiver of the landowner's right to forfeiture for failure of lessees to pay royalties due for prior months.

Suffice to say, such is not the law in California.

> "* * * And if thereafter he accepts rent accruing subsequent to the demand for possession or accruing subsequently to the commencement of the action, and accept it as rent *eo nomine,* that is, as payment under the original lease contract, he affirms that the lease is still in existence, and thereby waives a forfeiture that he has elected to enforce."
>
> *Jones v. Maria,* 48 Cal. App. 171.

> "The authorities are uniform to the effect that the forfeiture of a lease for breach of covenant, with full knowledge thereof on the part of the lessor is waived by acceptance of rent which accrues after the breach. (*Jones v. Maria,* 48 Cal. App. 171 (191 Pac. 943); *Inman v. Schecher,* 86 Cal. App. 193 (260 Pac. 605): 15 *Cal. Jur.* 787, sec. 205; * * *."
>
> *Keating v. Preston,* 42 Cal. App. (2d) 110, 121.

Conclusion.

In their brief, Appellees of Wells No. 2 and 4 argue that they accepted the plan with the understanding that the only thing that was called into question was waiver by conduct prior to the commencement of the bankruptcy proceedings. The record is barren of any support of the statement that these appellees accepted the plan with any definite understanding, or that they accepted the plan at all. It will be evident from the record that provision was made in the plan for priority only to such of the landowners as had acquired a right of forfeiture. It is apparent also that the provisions of the plan were drafted in such a manner as to constitute the plan "fair, equitable and feasible," as required by section 366 of the Bankruptcy Act of 1938. It would have been unfair to have preferred landowners who did not possess the immediate right of forfeiture, in view of the fact that their status in ordinary bankruptcy would have been that simply of unsecured creditors. It would have been unfair to the other unsecured creditors of this estate to have provided for full payment to such holders of landowners' royalties as had no prior claim against the assets of this estate. It is only where the landowner has the option to terminate a valuable executory contract that it would be fair to afford prior payment to such landowner. Collier on Bankruptcy, 14 Ed., Vol. 8, p. 1184.

Under the revised plan of arrangement, unsecured creditors received dividends for their claims in the form

of the stock of El Segundo Oil Company to which company was transferred all of the assets of the debtor corporation. The value of such stock to the holders thereof would be reduced by affording priority to these appellees. The revised plan merely provided that only where such appellees had perfected a right of forfeiture that they should receive priority and thus diminish the dividend to the unsecured creditors at large. It was for this reason that conditions were attached whereunder landowners' royalties would be preferred and not otherwise. These conditions were (1) that they had acquired the right of forfeiture and (2) that such right had not been waived either in conduct or otherwise. Examining the evidence, we find that the appellees failed to meet the very first condition. Their royalties did not carry with them the right of forfeiture because they failed to comply with the very first step necessary to create the right of forfeiture, to-wit, the giving of notice of default required by the leases. The evidence reveals that under the second condition the appellees could not qualify for the priority that they sought. Any rights of forfeiture that might have arisen had they given proper notice was waived by their acceptance of current royalties from the receiver. It was also waived by the conduct of the appellees in recognizing the subsistence of the lease and permitting the receiver and the debtor to operate in reliance upon the fact that the leases were not being forfeited. The evidence reveals that the receiver borrowed money and improved the property after notice to the landowners, and no steps were

taken by the landowners to deny the subsistence of the lease or to notify the debtor or its receiver that there was any intention to declare a forfeiture [R. 113 to 117, inclusive]. Having failed to qualify themselves for the preferred role that they seek, we feel the court below should have relegated the claims of the appellees to the status of unsecured creditors. We respectfully urge such direction from this Court.

Respectfully submitted,

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